## I. INTRODUCTION

All miscellaneous asset accounts which may not be appropriately included in the major balance sheet categories are listed as Other Assets. The following accounts are those most frequently encountered or otherwise deemed worthy of mention.

## II. PREPAID EXPENSES

This account is used as a means of allocating expenditures for services which will benefit the bank through future periods of time. Periodically over the life of the purchased goods or services, a portion of the cost is charged to current expenses with a corresponding credit to the prepaid expense account. Examples are premiums paid for surety bonds and other insurance and advance rental payments for bank premises and/or equipment. Examiners should be alert for evidence of failure to make proper adjusting entries to this account as the purchased goods or services are exhausted. Any overstatement should be classified Loss, but under no circumstances should an item be adversely classified that has been properly booked and is being handled according to accepted accounting principles.

## III. ACCRUED INCOME ACCOUNTS

The balance carried on the bank's books under this designation is actually a controlling account representing the total of a number of subsidiary records used for accruals of income receivable from different types of earning assets. In accrual accounting, a bank regularly credits to an applicable earnings account income earned but not yet collected. Since a cash equivalent has not been received at the same time, the bank must offset the credit by an entry (a debit) to the receivable account. When the income is actually collected, cash or equivalent is debited and the receivable account credited. The examiner should determine whether any of the income earned but not collected carried in this account is contingent upon items in default or otherwise of doubtful collection. Aside from the question of collectability, the general accuracy of the accrual system is also a material consideration and a matter which must be reviewed during the examination. The degree of examiner review of these accounts is essentially governed by the internal control procedures accorded them and the extent to which they are analyzed during audits. To the extent there may be income overstatements in these accounts, losses would exist and, if material, should be scheduled in the examination report.

## IV. ACCEPTANCES

A bankers acceptance is an order in the form of a time draft or bill of exchange drawn on and accepted by a banking institution for payment by that institution at some future date. Such instruments are readily marketable and may serve as an important secondary reserve for the accepting bank. The bank's acceptance of this order from the drawer, by stamping across the face of the draft "ACCEPTED" and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by the bank to honor the time draft at maturity. Acceptances owned by the bank, those which the bank has discounted or purchased (regardless of whether they were executed by the bank under examination or another), should be reported as loans. Acceptances which the bank has executed, those drawn on and accepted by it, and which are outstanding, should be reported under miscellaneous assets as customers' liabilities on acceptances outstanding. Further discussion of bankers acceptances is contained in the International Banking Section of this Manual.

## V. MORTGAGE SERVICING RIGHTS

The purchased right to service mortgage loans owned by other financial institutions or investors is considered an intangible asset of a bank and represents the value assigned to the contractual right of an organization to service mortgage loans for other than its own account. (The right to service a bank's own loans should not be recorded as an asset.) Mortgage servicing rights may be acquired in three ways:

1. In a separate acquisition of a mortgage servicing portfolio; or

2. In a purchase of mortgage loans for resale; or

3. In a business combination.

Mortgage servicing arrangements generally provide for the servicing bank to maintain all mortgage records, assume responsibility for billing mortgagors, collect periodic payments, send notices, and perform all other tasks needed for mortgage loan administration. Many commercial and savings banks service mortgage loans, both those originated and owned by the bank itself and mortgages owned by other parties. Fees for servicing mortgage loans are generally based on a percentage of the principal balance of the outstanding loans.

**Accounting**

Accounting for mortgage servicing rights is prescribed by FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities. This statement specifically applies to all enterprises (such as commercial banks and thrifts) that conduct operations substantially similar to a mortgage banking enterprise. Under generally accepted accounting principles (GAAP), banks may obtain mortgage servicing rights through the purchase of a mortgage servicing portfolio, through a business combination effected under the purchase method, or by the purchase of a mortgage loan portfolio for which a commitment has been or will be obtained within 30 days to sell the loans to investors. Rights to service the bank's own loans should not be recorded as an asset. Other transactions involving rights to service mortgage loans do not generally result in the creation of mortgage servicing rights as an intangible asset. The accounting guidelines established by GAAP should normally be followed, including the principles set forth in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, and the AICPA industry audit guide, Audits of Banks. However, FDIC policy requires banks to amortize the value of mortgage servicing rights over their estimated life or 15 years, whichever is shorter.

A complete discussion on the accounting and reporting treatment for mortgage servicing rights is provided in the Glossary Section of the Instructions for the Preparation of Call Reports.

**Other Transactions**

In several other situations, the question of whether mortgage servicing rights should be capitalized may be raised, but generally no intangible asset is recorded. Sale of Mortgage Loans. When mortgage loans are sold and the buyer assumes the servicing function, the gain or loss to the seller is measured by the difference between the selling price and the carrying amount (less any applicable deferred loan fees) and no intangible asset is created. In addition, if mortgage loans are sold and the seller retains the servicing function, there is still no intangible asset recorded (except in the case of a purchase of a mortgage loan portfolio for resale under the conditions described above).

A problem may arise if servicing is retained when loans are sold and either the stated servicing fee rate is materially different from the normal servicing fee rate or no servicing fee rate is stated. In this case, the sales price of the loans would have to be adjusted to determine gain or loss on the sale to provide a normal servicing fee in each subsequent year. This adjustment would result in deferred amounts to be amortized to servicing fee income in future years.

Any gain or loss and the adjustment should be calculated as of the date of sale. The amount of the adjustment would be the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been stated. The adjustment ordinarily will approximate the present value, based on an appropriate discount rate, of the difference between normal and stated servicing fees over the estimated life of the mortgage loans. In addition, if normal servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans shall be accrued at the sale date. Retain Loans and Sell Servicing. When a bank that owns mortgage loans sells for cash or other monetary compensation the mortgage servicing rights, it does not recognize a gain on the sale of the servicing nor create an intangible asset for its own account. In this transaction, the proceeds from the sale of the servicing are treated as an adjustment to the loan yield and are to be deferred and amortized in a manner similar to a discount on a loan. Swaps of Mortgage Servicing Rights.

Since loans originated by a bank do not result in the recording of a mortgage servicing intangible asset while the purchase of servicing rights form another entity does, transactions have been proposed where Bank A will purchase Bank B's mortgage servicing rights for cash and almost simultaneously Bank B will purchase Bank A's mortgage servicing rights for cash. Although the form of these transactions appears to satisfy the requirements of FASB Statement No. 65 for purchase of servicing rights, the substance is, in fact, a swap by the banks of similar mortgage servicing rights. If considered acceptable practice, this transaction would enable each bank to book "purchased mortgage servicing rights" where there had been no prior asset value and would have the effect of increasing capital without the infusion of any monetary or other assets. Similar transactions involving three or more institutions or involving direct swaps of mortgage servicing rights between institutions without cash payments remain, in substance, an exchange of similar assets -- mortgage servicing rights.

An exchange, in substance, of similar assets is addressed in APB Opinion No. 29. Paragraph 22 of this opinion provides that the accounting for assets exchanged, when not essentially the culmination of an earnings process, be based on the book value of the asset exchanged. The type of exchange described above is viewed as not essentially the culmination of an earnings process, but a transaction motivated by other factors. Consequently, no new intangible asset consisting of mortgage servicing rights would be created and the exchanged asset would be valued on the same basis as the old, adjusted for the net amount of any monetary assets given or received in the exchange. Since mortgage servicing rights on loans originated by a bank are not recorded as an asset on the books of the bank, the rights have, in effect, a zero book value to the originating bank, and the value would generally remain zero if this type of exchange were effected.

## Valuation

Many factors are usually considered in determining a market value for purchased mortgage servicing rights. The potential income stream from these factors is discounted to a present value basis to determine the dollar value for the servicing rights. Some of these include:

1. Average loan balance;
2. Expected servicing fees;
3. Average age of the portfolio;
4. Anticipated rate at which loan balances will be repaid by the borrower;
5. Percentage of loans on which escrow balances will be repaid by the borrower;
6. Delinquency rate and the average collection fee;
7. Degree of penetration of optional insurance sales and other ancillary income possibilities; and
8. Direct costs of servicing and the effect of the inflation rate on costs of servicing.

Purchase prices for mortgage servicing rights portfolios may vary greatly. For example, a portfolio of loans whose interest rates are well above current rates would trade in a lower price range. These high rate loans would be expected to be refinanced more quickly than a portfolio of current or lower rate loans, so that they would be of less value to a purchaser than a portfolio of loans whose interest rates are at current rates. A low interest rate portfolio also may not trade at a high rate because the loans are probably older. The older loans usually have lower loan balances and thus relatively low net servicing income.

Servicing Fees. Mortgage servicing fee rates also vary and depend on the terms of the servicing agreement. However, annual mortgage servicing fee rates are generally in the range of 0.25 to 0.50 percent of the principal balance of the mortgage loan portfolio. Servicers of GNMA securities normally receive annual servicing fees, net of insurance fees, of 0.44 percent of the outstanding loan amount. GNMA pools call for this serving fee rate and some consider this as the normal servicing fee rate contemplated by FASB No. 65.

## Servicing Risk

Examiners should always be aware of the importance of the risks that can accrue to an institution from the failure to follow the servicing rules attendant to securitized assets. While credit risk may appear to be of little or no concern, the mishandling of procedures by one or more of the many parties involved in these transactions can affect a holder's ability to collect. Financial institutions perform roles as sellers, buyers, servicers, trustees, etc. in these types of transactions. Examiners should be alert to the need to evaluate any and all potential risks that might arise from one or more of these roles. In most cases, the government agency that has provided the guarantee or insurance against ultimate default will also impose guidelines and regulations for the servicer to follow. If the servicer or another party to the program fails to follow these rules and guidelines, then the government agency that is providing the guarantee or insurance may fail to honor its commitment to insure all parties against loss due to default. It is necessary for the financial institution to have adequate policies and procedures in place to control and limit the institution's liability and exposure in this regard.

### Examination Procedures

When assessing asset quality during onsite examinations and when reviewing merger applications, examiners and supervisory personnel should review the valuation and accounting treatment of mortgage servicing rights. This review should generally include the following procedures:

1. Review information obtained from the bank regarding the value at which mortgage servicing rights were recorded, the estimated annual servicing fees, the amortization periods and the date of the bank's last review of the appropriateness of the book value and amortization period of these assets.

2. Ascertain that the mortgage servicing rights are being amortized over their estimated life or 15 years, whichever is shorter.

3. Determine that at least once each year the bank has analyzed the book value of the intangible assets and the appropriateness of the amortization periods. Note whether any write-downs have occurred as a result of these reviews and whether the reviews were conducted by management, consultants or outside auditors.

4. Review the bank's records to determine that mortgage servicing rights acquired and recorded since the last examination are properly valued at the lower of cost or estimated future net servicing income, that any excess acquisition cost has been charged off, and that the amortization periods appear appropriate. For example, examiners should review records that identify:(a) the mortgage loans balances; (b) the facts and assumptions supporting the estimated lives of the loans and the amortization method used; © the future net income stream; (d) the present value of the future net income stream; and (e) the discount rate used to calculate the present value and the justification for using that rate.

5. Evaluate the impact of mortgage servicing rights on the financial condition of the organization and consider whether the book value should be reduced to a more reasonable amount. If the value of the mortgage servicing rights is overstated, the excess amount should be classified Loss.

Any concerns noted in this review should be discussed with management and identified in the examination report, as appropriate.

## VI. ALL OTHER ASSETS Suspense Accounts

Various temporary holding accounts may be included within the designation of suspense accounts, such as interoffice, teller, transit and bookkeeping differences having debit balances. These accounts should only be used for temporary recording until the offsetting entry is received or fully identified and posted to the proper account. Outdated items carried in suspense are likely uncollectible and should be classified Loss in the examination report.

### Cash Items Not in Process of Collection

This caption is comprised of such items as checks returned by other banks, checks not posted by bookkeepers for various reasons, and any other unpaid items which do not conform to the definition of Cash Items in Process of Collection. Checks held by a bank to avoid showing overdrafts in depositors' accounts, even though paid or otherwise disposed of during the examination, should be shown as "not in process of collection".

The maintenance of a detailed permanent record of all cash items is essential. Inadequate bank records have facilitated concealment of shortages through manipulation of cash items. Cash items should not be kept as part of tellers' cash, but instead should be charged to a general ledger account and handled as collection items, with responsibility assigned to one person who preferably does not handle cash. All entries to the account should require officer approval, and in no case should this officer also be custodian of the items. Examiners should recommend to management that adequate records and accepted accounting procedures be followed in the handling of all cash item transactions.

Cash items and cash item entries should be thoroughly investigated, especially cash item transactions occurring immediately before and after the date of the current examination and for a period following the close of the previous examination.

### Future Tax Benefits

These accounts may occasionally be encountered on the bank's books under such captions as Future Tax Benefits, Deferred Income Tax Charges, and Prepaid Income Taxes. Future Tax Benefits' accounts must be evaluated in light of the prevailing fact situation and the documentary evidence and support on which they rest. Assets falling within the Future Tax Benefits' category arise from two distinct types of circumstances: (1) timing differences (i.e., those items reported on the tax return of one period and on the income statement of another period) which result in the payment of income taxes prior to reporting the related tax expense for financial statement purposes; and (2) carryforwards from past and current tax returns which will enter into tax computations on future returns.

A special example of a timing difference may arise when a change in accounting for discounted instalment loans is made from the consistent application of the cash basis for tax and financial purposes to the accrual basis for both purposes. It is not unusual for the Internal Revenue Service to condition its permission to make this change with a requirement that an adjustment be made to the books by crediting an unearned discount liability account for discounts, calculated on an accrual basis, which have not been earned at the time of the accounting method changeover. Since the discounts credited to the liability account have previously entered into taxable income in accord once with cash basis reporting, subsequent accrual reporting will carry these discounts into taxable income a second time. To avoid double taxation, offsetting deductions which in total equal the liability adjustment, are generally allowed over a series of years with the offset for any one year usually limited to 10% of total offsets allowed. Under these circumstances, it may be appropriate to show the future tax effect of unused offsetting deductions as an asset. However, since realization of tax effect can be made only when taxable income is reported, no asset recognition would be appropriate if the deduction must be used within a fixed period and if at the same time there is reasonable doubt concerning the bank's ability to produce taxable income within the prescribed period.

Net taxable losses are examples of potential tax benefits of the carryforward variety. To the extent not utilized by obtaining tax refunds, losses are carried forward for a limited number of years and used to reduce income that would otherwise be taxable. However, realization of the tax benefit is generally questionable, since it is dependent upon future taxable income. Accordingly, the tax effects of loss carryforwards should not be recognized until they are actually realized, except in unusual circumstances when realization is assured beyond any reasonable doubt at the time the loss carryforwards arise. Realization would appear to be assured beyond a reasonable doubt when both of the following conditions exist: (1) the loss results from an identifiable, isolated, and nonrecurring cause and the bank either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years; and (2) future taxable income is virtually certain to be large enough to offset the loss carryforward and will occur soon enough to provide realization during the carryforward period. This latter judgment may be difficult to make in some situations and it is suggested that the examiner consult with the Regional Office in borderline cases involving significant amounts.

### All Other Assets

It is virtually impossible to develop a complete list of miscellaneous assets which the examiner may encounter. The more common are detailed in the paragraphs that follow.

Accrued interest on bonds purchased results when a bank purchases fixed income securities at times other than coupon dates. Since there is no practical way to have the debtor on the instrument divide the interest within the coupon period, it is customary at settlement to add to the purchase price a sum equaling interest from date of the previous coupon to date of sale. At the first coupon date the new owner cancels the accrued interest paid and credits the remainder of the coupon to securities income or interest receivable, depending on the accounting system. Failure to reverse the original entry at the time payment is received creates an overstatement of income, which warrants a Loss classification.

Life insurance policies insuring the lives of key officers may be bank assets, as may policies acquired DPC on the lives of borrowers. In neither case should book values exceed cash surrender values. Substantial amounts of cash value in excess of carrying value may be shown in the report as Sound Banking Values Not Shown on Books. Overstatements should be classified Loss.

Reimbursable insurance claims should be supported by factual evidence of the claim, and no adverse classification will be made if the bank has a bona fide reimbursement due from an insurance company. Items subject to litigation or negotiation prior to settlement should be appraised on their individual merits, and any adverse classification must be supported by factual and convincing comments.

Bonding company claims arising from acts involving directors, officers, or employees of the bank, however, often pose complex legal problems which cast a cloud of uncertainty on their validity or collectability. Capitalization of such claims before their realization is rarely justified, unless the surrounding factual situation is such that realization is assured beyond any reasonable doubt. As a general rule, examiners should consult with the Regional Office when material claims of this nature are encountered.

To determine whether a pending claim has merit, examiners should review:

1. the bank's documentation that demonstrates fraud has been committed;
2. terms of the bank's bonding coverage;
3. bank counsel's opinion as to the legality, collectibility, and amount of the claim;
4. internal/external auditors' opinions concerning the proper accounting of the claim (if available);
5. the bank's compliance with the insurance company's filing requirements; and
6. communications from the insurance company.

Repossessions represent assets to which the bank has taken title in full or partial satisfaction of debt. The usual kinds of property are automobiles, appliances, trucks, and other heavy equipment used in construction. There may very well be elements of loss evident in each repossession transaction. Each repossessed item should be considered on an individual basis and adversely classified on the basis of facts supporting the examiner's appraisal.

Life Insurance Policies

The business life insurance policies purchased by banks may be intended to serve as both protection from the mortality risk of key employees and an investment. Accounting for life insurance purchased by businesses is addressed in FASB Technical Bulletin No. 85-4, dated November 14, 1985.

Examiners should review the bank's commitment in these policies to determine whether the size of the policies is appropriate for the size of the bank, whether the officers are, in fact, "key" employees, and given the frequently low rate of return built into insurance contracts, whether the bank in question can maintain an asset that is, in effect, losing money. Excessive investment in this asset would be worthy of comment in the examination report.